Hastings Law Journal

Volume 57 | Issue 4 Article 5

1-2006

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Lee B. Shepard

Beyond *Moody*: A Re-Examination of Unreasonably Small Capital

LEE B. SHEPARD*

INTRODUCTION

Fraudulent conveyance laws have faded from the legal spotlight following the aftermath of the leveraged buyout boom in the late 1980s and early 1990s. In recent years, as the economy has improved, the number of leveraged buyouts has increased,[1] fueled by aggressive financing techniques such as second lien financing.[2] Mergers and acquisitions are on the rise.[3] Other types of corporate transactions that can raise fraudulent conveyance issues are becoming more popular, such as leveraged recapitalizations, spin-offs and certain internal corporate reorganizations.[4] Since directors and other fiduciaries are more aware of their duties and personal exposure to liability than in the past, and lenders are considerably less aggressive than they were at the peak of the leveraged buyout (LBO) craze, the risk of abusive 1980s-style transactions that could immediately render companies insolvent may be low.[5] Consequently, future fraudulent conveyance cases may be more likely to result from transactions that leave a company in a weakened

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* J.D. Candidate, University of California, Hastings College of the Law, 2006. I am grateful to Professor Frederick W. Lambert for his helpful comments, and to my family for their patience and support.

1. *See* STANDARD & POOR'S, INC., Q4 2004 LEVERAGED BUYOUT REVIEW 14–16 (2005). In addition, loans made to finance LBOs increased more than four-fold from 2002 to 2004. *Id.* at 1. As a result, many financial advisory firms are hiring staff in anticipation of business failures resulting from an end to the global credit boom. *See* Jennifer Hughes et al., *Insolvency Advisors are Hiring More Staff*, FIN. TIMES (LONDON), Mar. 14, 2005, at 1.

2. The total volume of institutional second lien loans increased from $65 million in 2001 to $12.2 billion in 2004. STANDARD & POOR'S, INC., LEVERAGED COMMENTARY AND DATA (LCD) 24 (Mar. 3, 2005).

3. *See* Andrew R. Sorkin, *Wall Street's Designs on '05? A Boom in Merger Activity*, N.Y. TIMES, Jan. 2, 2005, at 1.

4. An example of a corporate reorganization raising fraudulent conveyance issues would be when an operating subsidiary with a substantial amount of debt or contingent liabilities (such as environmental or tort liabilities) transfers key assets such as intellectual property to an affiliate, leaving fewer or less desirable assets behind to satisfy the liabilities.

5. *See* Hughes et al., *supra* note 1, at 1 ("[T]he market is more aware of the risks than in previous credit cycles.").

financial state just short of insolvency—for example, a company that had unreasonably small capital. These types of transactions may also raise related issues, such as directors' fiduciary duties to creditors in the "zone of insolvency," a rapidly growing and controversial area of law.

Unreasonably small capital, also referred to as unreasonably small assets, is a financial condition that is an element of constructive fraud on creditors addressed by the Uniform Fraudulent Conveyance Act (UFCA), Uniform Fraudulent Transfer Act (UFTA) and Section 548 of the Bankruptcy Code (Section 548). Since no statute defines unreasonably small capital,[6] the courts have been left to determine what unreasonably small capital means and when a company is left with it.

While fraudulent conveyance laws have existed since the Roman Empire,[7] unreasonably small capital is an underdeveloped concept. Prevailing case law, exemplified by *Moody v. Security Pacific*,[8] defines unreasonably small capital as a financial condition short of equitable insolvency.[9] The general approach adopted by Moody and followed by many courts to determine whether a company has unreasonably small capital is a fact-based test of whether the company's cash flow forecasts are reasonable and leave enough margin for error to account for reasonably foreseeable difficulties.[10] This could be described as a "cash flow cushion" test.[11]

This Note explores the purpose of the unreasonably small capital element in fraudulent conveyance law and proposes that unreasonably small capital be defined as a financial condition that poses an unreasonable risk of loss to creditors.[12] It proposes a broad-based test of all facts and circumstances to determine when a company has unreasonably small capital (unreasonable risk of loss to creditors), including the amount of cash flow, equity cushion,[13] and other factors that impact creditworthiness, including criteria used by ratings agencies such as Standard & Poor's and Moody's. Part I describes fraudulent

6. *See, e.g.*, Brandt v. Hicks, Muse & Co., Inc. (*In re* Healthco Int'l Inc.), 208 B.R. 288, 302 (Bankr. D. Mass. 1997) (meaning of unreasonably small capital not defined in fraudulent transfer statutes); Vadnais Lumber Supply, Inc. v. Byrne (*In re* Vadnais Lumber Supply, Inc.), 100 B.R. 127, 137 (Bankr. D. Mass. 1989) (unreasonably small capital not defined in the UFCA or Section 548).

7. *See infra* note 23.

8. Moody v. Sec. Pac. Bus. Credit, Inc., 971 F.2d 1056, 1064 (3d Cir. 1992).

9. *Id.* Equitable insolvency is often referred to as cash flow insolvency, a condition where a company's cash flow is insufficient to pay its liabilities as they come due.

10. *Id.* at 1073.

11. *See infra* notes 134-38 and accompanying test.

12. *See infra* note 171 and accompanying text; Barry L. Zaretsky, *Fraudulent Transfer Law as the Arbiter of Unreasonable Risk*, 46 S.C. L. REV. 1165, 1168 (1995). Professor Zaretsky suggested that fraudulent transfer laws generally serve to prevent companies from taking unreasonable amounts of risk, a purpose not originally contemplated when the fraudulent transfer laws were promulgated. *Id.*

13. Cash flow cushion refers to the excess of cash flow over the amount of cash required to pay liabilities as they come due. Equity cushion refers to the amount by which assets exceed liabilities.

conveyance law and unreasonably small capital, and traces its development from inception during the Roman Empire through the adoption of the UFCA, the first uniform national fraudulent conveyance statute, enacted in 1918. Part II discusses existing case law on unreasonably small capital. Finally, Part III suggests an alternative approach to unreasonably small capital based on the proposition that unreasonably small capital means unreasonable risk of loss. The approach considers: the goals of fraudulent conveyance laws, judicial precedent, and how creditors (including rating agencies) assess credit risk.

I. FRAUDULENT CONVEYANCE LAW

A. INTRODUCTION

Modern fraudulent conveyance laws protect creditors by rendering transfers of assets constructively fraudulent and voidable, without regard to intent, when the transferor did not receive adequate consideration and was, or was thereby rendered, insolvent or nearly insolvent.[14] They also protect creditors from intentional fraud—transfers of assets made with the intent to "hinder, delay or defraud any creditor of the debtor."[15] While early fraudulent conveyance cases and statutes focused on intentional fraud, most attention in recent years has been paid to constructive fraud.[16] Courts have determined that fraudulent conveyance laws apply to leveraged buyouts and other transactions not intended to defraud creditors.[17] Fraudulent conveyance laws have existed since the

14. *See generally* UNIF. FRAUDULENT CONVEYANCE ACT, 7A U.L.A. 2 (1999); UNIF. FRAUDULENT TRANSFER ACT, 7A U.L.A. 266 (1999); 11 U.S.C. § 548 (2000). "Insolvent" can mean balance sheet or bankruptcy insolvency (assets do not exceed liabilities) or equitable insolvency (cash flow insufficient to pay debts as they mature). *See, e.g.*, Moody v. Sec. Pac. Bus. Credit, Inc., 971 F.2d 1056, 1063–64 (3d Cir. 1992); Brandt v. Hicks, Muse & Co., Inc. (*In re* Healthco Int'l Inc.), 208 B.R. 288, 301 (Bankr. D. Mass. 1997) ("Insolvency has a settled meaning under fraudulent transfer law, whether the relevant statute be section 548 of the Bankruptcy Code, the [UFTA] or the [UFCA]. Its statutory definition is, in essence, an excess of liabilities over the value of assets. This is sometimes referred to as insolvency in the bankruptcy sense."); MFS/Sun Life Trust v. Van Dusen Airport Servs. Co., 910 F. Supp. 913, 943 (S.D.N.Y. 1995) (defining equitable insolvency as a condition where a debtor is unable to pay its debts as they come due).

15. UNIF. FRAUDULENT TRANSFER ACT § 4(a)(1), 7A U.L.A. 652–53, 657 (1985).

16. *See, e.g.*, Zaretsky, *supra* note 12, at 1165–66.

17. *See Moody*, 971 F.2d at 1064 ("We think it settled, as a general matter at least, that the fraudulent conveyance provisions of the UFCA extend to [LBOs]."); *MFS/Sun Life Trust*, 910 F. Supp. at 933 ("[C]ourts now uniformly hold that fraudulent conveyance laws apply to LBOs.").

> [E]ven if the collusive aspects of the Elizabethan paradigm may not be present in an arm's-length LBO, creditors will suffer the same type of harm the laws were designed to remedy if the target is rendered insolvent.... Thus, it matters little whether a creditor is unable to recover because an individual debtor has secreted assets or because a corporate debtor has been gutted by former owners who reap the proceeds of an LBO.

Id. But see Kupetz v. Wolf, 845 F.2d 842, 850 n.16 (9th Cir. 1988) (UFCA's constructive fraud provisions do not apply to LBOs that are publicly disclosed); Credit Managers Ass'n of S. Cal. v. Fed.

Roman Empire, and while today they may be applied to more sophisticated transactions than in the prior years, their purpose has always been to protect creditors from fraudulent diminution of a debtor's assets.[18]

Today, fraudulent conveyance laws are codified in the UFTA, UFCA (the predecessor to the UFTA and still in effect in some jurisdictions), and Section 548 of the Bankruptcy Code. While the wording of these statutes differs, they each operate in a similar manner. Courts will find constructive fraud when a debtor transferred an asset without receiving reasonably equivalent value, and either before or after the transfer, (a) assets did not exceed liabilities (the "balance sheet" test), (b) the debtor was unable to pay its debts as they came due (the "cash flow" test), or (c) the debtor was left with unreasonably small capital for the business in which it is engaged (the "unreasonably small capital" test).[19]

B. UNREASONABLY SMALL CAPITAL TEST

Fraudulent conveyance laws would not be effective if they only applied to debtors rendered insolvent by asset transfers. If so, a company could transfer just enough assets to leave it barely solvent.[20] For example,

Co., 629 F. Supp. 175, 179 (C.D. Cal. 1985) (questioning whether fraudulent conveyance laws apply to LBOs). For criticism of the latter view, see *Zahn v. Yucaipa Capital Fund*, 218 B.R. 656, 667–72 (Bankr. D.R.I. 1998) (criticizing *Kupetz*, *Credit Managers* and other Ninth Circuit decisions questioning whether fraudulent conveyance laws apply to LBO's); *id.* at 672 ("[T]he Ninth Circuit decisions on this subject are federal judicial legislation at its worst."); *see also* Orr v. Kinderhill Corp., 991 F.2d 31 (2d Cir. 1993) (finding that a corporation's spin-off of real estate assets to shareholders was a fraudulent conveyance).

18. *See* Pajaro Dunes Rental Agency, Inc. v. Spitters (*In re* Pajaro Dunes Rental Agency, Inc.), 174 B.R. 557, 571 (Bankr. N.D. Cal. 1994) ("The purpose [of a fraudulent conveyance action] is to prevent valuable assets from being transferred away from debtors in exchange for less than fair value, leaving insufficient funds to compensate honest creditors."); Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 777 (Del. Ch. 2004) ("[T]he law of fraudulent conveyance exists specifically to protect creditors."); 1 GARRARD GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES 348 (rev. ed. 1940) (the "real test of a fraudulent conveyance . . . is the unjust diminution of the debtor's estate."); Louis Edward Levinthal, *The Early History of Bankruptcy Law*, 66 U. PA. L. REV. 223, 239 (1918) [hereinafter Levinthal, *The Early History*] (discussing Roman fraudulent conveyance law) ("Any act or forbearance by which a debtor diminished the amount of his property divisible among his creditors was held to be in fraud of creditors.").

19. *See, e.g.*, Pereira v. Farace, 413 F.3d 330, 343 (2d Cir. 2005) ("The Cash Flow test projects into the future to determine whether capital will remain adequate over time . . . ."); Mellon Bank, N.A. v. Metro Commc'ns, Inc., 945 F.2d 635, 648 (3d Cir. 1991) (describing the balance sheet test under Section 548); Peltz v. Hatten, 279 B.R. 710, 742–43 (Bankr. D. Del. 2002). Throughout this Note, I refer to "unreasonably small capital," a term that appears in the UFCA and Bankruptcy Code. Although the UFTA uses the words "unreasonably small assets," they have substantially the same meaning. *See* Vadnais Lumber Supply, Inc. v. Byrne (*In re* Vadnais Lumber Supply, Inc.), 100 B.R. 127, 137 (Bankr. D. Mass. 1989) ("The [UFTA] substitutes assets for capital in order to avoid possible confusion with the corporate law concept of capital, funds permanently invested in the business, which has no relevance in fraudulent transfer law." (internal quotations omitted)).

20. *See Moody*, 971 F.2d at 1070 n.22. The unreasonably small capital test only applies to debtors

if a company's assets exceeded its liabilities by $1.00, it would be deemed balance sheet solvent and pass the balance sheet test. Alternatively, if a company's projected future cash flow were just enough to pay its debts as they came due and no more, it would be equitably solvent and pass the cash flow test. In either case, the company's creditors would be exposed to a high, and arguably unreasonable, degree of risk. Although some companies left in this condition may prosper and pay its creditors, most will be "doomed to failure."[21] Involuntary creditors of such companies are unprotected against the slightest adverse development, foreseen or unforeseen.[22]

To prevent this type of harm to creditors, purposeful or not, fraudulent conveyance laws prevent asset transfers that leave debtor companies on the verge of insolvency. Although UFTA, UFCA and Section 548 describe this condition using different words, the concept is the same: unreasonably small capital means insufficient capital or assets for the business in which the debtor is engaged. The problem in applying the unreasonably small capital test is determining when capital, or assets, become unreasonably small. Protection from transactions leaving unreasonably small capital is closely related to other laws that protect creditors from undercapitalization, such as statutory dividend restrictions, alter ego liability (piercing the corporate veil) for initial undercapitalization, and directors' fiduciary duties to creditors when a corporation is in the "zone of insolvency."

C. Development of Fraudulent Conveyance Law and the Unreasonably Small Capital Test

1. Early History

Fraudulent conveyance laws, used to attack leveraged buyouts in the 1980s and beyond, have existed for over a thousand years, dating back to the Roman Empire.[23] Roman fraudulent conveyance laws applied to acts

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engaged in, or about to engage in, business. *See, e.g.*, UNIF. FRAUDULENT TRANSFER ACT § 5, 7A U.L.A. 105 (1999) ("Conveyances by Persons in Business."). Therefore, in this Note, the word "company" refers to a debtor engaged in business, regardless of the debtor's legal form.

21. *See* Daley v. Chang (*In re* Joy Recovery Tech. Corp.), 286 B.R. 54, 76 (Bankr. N.D. Ill. 2002) ("Unreasonably small capital means . . . the transaction in issue put [the debtor] on the road to ruin."); Geron v. Schulman (*In re* Manshul Constr. Corp.), 97 Civ. 8851, 99 Civ. 2825, 2000 U.S. Dist. LEXIS 12576, at *154 (Bankr. S.D.N.Y. Aug. 30, 2000) ("The [unreasonably small capital] test is aimed at transfers that leave the transferor technically solvent but doomed to fail.").

22. *See Moody*, 971 F.2d at 1073 n.27.

23. *See* ORLANDO F. BUMP, FRAUDULENT CONVEYANCES: A TREATISE UPON CONVEYANCES MADE BY DEBTORS TO DEFRAUD CREDITORS 6 (3d ed. 1882) ("Roman Law is the oldest law upon the subject of fraudulent conveyances, and embodies all the leading principles."); GLENN, *supra* note 18, at 82 ("In Roman law . . . fraudulent conveyance was fully recognized."); Levinthal, *The Early History*, *supra* note 18, at 239 ("In Roman law . . . elaborate provisions for vitiating fraudulent transfers of property belonging to insolvent debtors were framed."). Translations of many Roman fraudulent conveyance statutes may be found in Max Radin, *Fraudulent Conveyances at Roman Law*, 18 VA. L. REV. 109

or forbearances "by which [an insolvent] debtor diminished the amount of his property divisible among his creditors."[24] Such acts were deemed fraudulent as to creditors and were rescindable.[25] One of the more general statements of Roman fraudulent conveyance law is found in the Institutes of Justinian, 4, 6, 6:

> [I]f any one has transferred his property to another in fraud of his creditors, upon judgment to that effect by the chief provincial magistrate, the creditors of the transferor may seize his property, avoid the transfer, and recover the things transferred; this is, they may claim that the things have not been transferred at all and accordingly are still within the legal possession of the debtor.[26]

Fraudulent debtors were subject to arrest, imprisonment, religious sanctions and death.[27] Intent to defraud creditors was not always required: at least one ancient case recognized constructive fraud.[28] While Roman fraudulent conveyance laws were meant to recover improperly transferred property, so that it could be available for division among creditors, Roman bankruptcy laws (the source of modern bankruptcy law) were concerned with the sale of debtors' property and pro-rata division of proceeds among creditors.[29]

Roman fraudulent conveyance laws developed in tandem with other debtor-creditor laws as commerce evolved.[30] In ancient times, credit was virtually unheard of.[31] As the notion of credit developed, so did the need for collections. A creditor's original remedy was execution against the person.[32] There were severe penalties for nonpayment.[33] Execution

(1931).

24. *See* Levinthal, *The Early History*, *supra* note 18, at 239.

25. *Id.* ("If the transfer was without consideration, [it] was rescinded, even if the grantee were wholly innocent. If the grantee had notice of the fraud, the transfer was rescinded, even if it were with valuable consideration."). In addition, Roman law deemed all acts of a debtor within a thirty day "suspicious period" prior to actual insolvency to be presumptively fraudulent. *See* GLENN, *supra* note 18, at 82–83. This is arguably the origin of the modern preference period contained in § 547 of the Bankruptcy Code.

26. Radin, *Fraudulent Conveyances at Roman Law*, *supra* note 23, at 109 (quoting J. INST. 4.6.6).

27. *See* BUMP, *supra* note 23 at 4–5; Levinthal, *The Early History*, *supra* note 18, at 231, 238.

28. *See* Radin, *Fraudulent Conveyances at Roman Law*, *supra* note 23, at 122–23 ("Although it is not alleged that he intended to defraud his creditors, nevertheless, when a man knows that he has creditors and alienates all his property, it must be assumed that he intended to defraud them, and therefore his sons are held liable even if they did not know that such was the intention of their father." (translating and paraphrasing JULIAN'S DIGEST bk. 49)).

29. *See* Levinthal, *The Early History*, *supra* note 18, at 235–37. The "Roman system of bankruptcy ... is in fact the origin and fountain-head of all bankruptcy systems." *Id.* at 236.

30. *See* BUMP, *supra* note 23, at 1–7.

31. *See* BUMP, *supra* note 23, at 1 ("In the earliest stages of society .... [t]here are neither loans nor debts, and commerce is unknown."); Levinthal, *The Early History*, *supra* note 18, at 228 ("In very primitive society ... debtors and creditors are unknown .... ").

32. *See* Levinthal, *The Early History*, *supra* note 18, at 229–32.

33. *See id.* In primitive law, a creditor could seize a debtor and force him to work for him, sell him and his relatives into slavery, "kill or maim [him], confine his wife, sons or cattle, or besiege him in his

against property was typically limited only to the state. Over time, creditors gained the right to proceed against a debtor's property as well as the person.[34] At first, there was a race of diligence where the creditors who seized property first won.[35] This free-for-all approach, similar to modern state debt collections laws, evolved into a more orderly bankruptcy system whereby the property of an insolvent debtor (subject, in some cases, to exemptions)[36] was sold and the proceeds divided among creditors, a process analogous to Chapter 7 bankruptcy.[37] Roman law also had an analog to Chapter 13 bankruptcy.[38]

In the Middle Ages, fraudulent conveyance laws found their way to England.[39] The English Parliament adopted a number of statutes, beginning with 50 Edw. III, ch. 6 (1376), to address the problem of debtors seeking sanctuary to avoid paying creditors.[40] This was a common

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home." *Id.* at 230. In Rome, a creditor could kill a deadbeat debtor by the "laying on of hands, a mode of execution which proceeded... with inexorable rigor." *Id.* at 231 (internal quotations omitted). If there were multiple creditors, they could "cut the debtor's body into pieces." *Id.*

34. *See id.* at 232.

35. *Id.* at 235. The system of individual proprietary execution against property "made payment the prize of a race of diligence and fostered fraud and collusion," making a system of bankruptcy a "pressing necessity." *Id.*

36. *Id.* at 237 ("[In Islamic] law... the honest but unfortunate debtor was allowed a definite amount as an exemption.").

37. Levinthal, *The Early History*, *supra* note 18, at 235–37. Property was sold *en bloc* at auction, or piecemeal by a "curator bonorum" appointed by the magistrate. *Id.* at 236. A "discharge" was only available to honest (nonfraudulent) debtors. *Id.* at 238 ("[A] debtor whose insolvency was not due to his own fault... escaped liability to arrest and imprisonment.... Moreover,... he was allowed to retain so much of his after[-]acquired property as was necessary for his subsistence."). Unlike modern bankruptcy, the debtor continued to remain liable for the unpaid balance upon once again obtaining wealth. *Id.* n.55.

38. *Id.* at 238 ("The debtor [could] apply to the emperor for an order requiring the creditors to choose by a vote whether they would proceed at once to a surrender and sale of the estate, taking their chances as to how far the available assets would go, or whether they would allow their debtor a period not exceeding five years in which to pay.").

39. GLENN, *supra* note 18, at 83 & n.13. Roman law was first adopted in England following the Roman conquest in 55 B.C. Hon. Arthur R. Emmett, *Roman Traces in Australian Law*, 20 AUSTL. BAR REV. 1, 15 (2001). It disappeared from English law following the withdrawal of the Roman legions by the fifth century A.D. *Id.* at 16. Roman law was reintroduced in England following the publication, in the 1190s, of a textbook written by a magister from Bologna, who had traveled to England at the request of the Archbishop of Canterbury. *Id.*

40. *See* GLENN, *supra* note 18, at 83 n.13 & 84; *see also* Harkness v. P'ship Pac. Ltd. (1997) 23 A.C.S.R. 1; Louis Edward Levinthal, *The Early History of English Bankruptcy*, 67 U. PA. L. REV. 1, 11–12 (1919) [hereinafter Levinthal, *English Bankruptcy*]. An earlier statute, 52 Hen. III, ch. 6, was adopted in 1266 to annul "any conveyance made with intent to defeat a lord of his wardship." GLENN, *supra* note 18, at 83 n.13.

> Because [debtors]... give their tenements and chattels to their friends, by collusion thereof to have the profits at their will, and after do flee to... privileged places, and there do live a great time with an high countenance of another man's goods and profits of said tenements and chattels, until the said creditors shall be bound to take a small parcel of their debt, and release the remnant,—It is ordained and asserted, that if it be found that such gifts be so made by collusions, that the said creditors shall have execution of the said tenements and chattels, as if no such gift had been made.

practice where a debtor would transfer property to a friend or other reliable third party and seek sanctuary in a church or other protected place where creditors could not enter.[41] The debtor would live there, continuing to enjoy the income from the transferred property until creditors agreed to accept a discounted settlement.[42] Afterwards, the transferee would reconvey the property back to the debtor, who would, now debt-free, live happily ever after.[43]

In 1571, Parliament adopted the Fraudulent Conveyance Act (commonly referred to as the Statute of Elizabeth).[44] The Statute of Elizabeth, which restated existing common law and statutes[45] and corresponded to Roman law,[46] is viewed as the basis for modern fraudulent conveyance law.[47] It was intended to protect creditors.[48]

2. *Early Common Law Development of the Unreasonable Capital Test*

The Statute of Elizabeth migrated to the United States and was universally adopted, with minor changes, by state legislatures.[49] The Statute of Elizabeth dealt solely with intentional fraud.[50] Prior to the adoption of the Uniform Fraudulent Conveyance Act in 1918, constructive fraud and what was later known as the unreasonably small

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Levinthal, *English Bankruptcy*, *supra*, at 11–12; *see also* FREDERICK S. WAIT, A TREATISE ON FRAUDULENT CONVEYANCES AND CREDITORS' BILLS 41–43 (3d ed. 1897) (tracing the history of English fraudulent conveyance statutes from 1376 to 1570).

41. *See* GLENN, *supra* note 40, at 84. Anybody who attempted to enter a church to collect a debt was subject to excommunication. Levinthal, *English Bankruptcy*, *supra* note 40, at 10. Over time, fraudulent conveyance statutes gave creditors greater rights to pursue debtors in sanctuaries. *Id.* at 10–16.

42. *See* GLENN, *supra* note 18, at 84; Levinthal, *English Bankruptcy*, *supra* note 40, at 11–12.

43. *See* Mellon Bank, N.A. v. Metro Commc'ns, Inc., 945 F.2d 635, 645 (3d Cir. 1991); GLENN, *supra* note 18, at 84.

44. *See Mellon Bank*, 945 F.2d at 644 (Statute of Elizabeth passed by Parliament in 1571); GLENN, *supra* note 18, at 43; HENRY W. MAY, A TREATISE ON THE STATUTES OF ELIZABETH AGAINST FRAUDULENT CONVEYANCES 495–99 (1871). The Statute of Elizabeth remained in force in England until replaced in 1925. Max Radin, *Fraudulent Conveyances in California and the Uniform Fraudulent Conveyance Act*, 27 CAL. L. REV. 1, 2 (1939) [hereinafter Radin, *Fraudulent Conveyances in California*].

45. *See* MAY, *supra* note 44, at 2, 6–8; Radin, *Fraudulent Conveyances in California*, *supra* note 44, at 2.

46. *See* Harkness v. P'ship Pac. Ltd. (1997) 23 A.C.S.R. 1 (citing HENRY W. MAY, A TREATISE ON THE STATUTES OF ELIZABETH AGAINST FRAUDULENT CONVEYANCES 6–8 (3d ed. 1908)).

47. BUMP, *supra* note 23, at 10.

48. *See id.* at 1.

49. *See* Peters v. Bain, 133 U.S. 670, 685 (1890) ("The statute of Elizabeth, [ch.] 5, against fraudulent conveyances has been universally adopted in American law as the basis of our jurisprudence on that subject ... and reenacted in terms, or nearly so, or with some change of language, by the legislatures of the several States." (internal citation omitted)).

50. *See* UNIF. FRAUDULENT CONVEYANCE ACT PREFATORY NOTE, 9B U.L.A. 71 (1966) ("The Statute of Elizabeth condemns conveyances as fraudulent only when made with the 'intent' to 'hinder, delay or defraud.'"). *But see* MAY, *supra* note 44, at 4 (noting that the Statute of Elizabeth was also directed against constructive fraud).

capital test developed in common law.[51]

Carpenter v. Roe, decided in 1851, was one of the first known cases to address unreasonably small capital.[52] In *Carpenter*, defendant Roe, a produce merchant, and his wife, transferred real property to their son-in-law for no consideration.[53] One week later, news arrived via steamer that the price of grain had plunged,[54] and Roe became "utterly insolvent."[55] His creditors brought a fraudulent conveyance action to set aside the transfer.[56] The court voided the transfer, holding that even if Roe was not insolvent at the time of the transfer, "[i]t was sufficient that he was indebted, and that insolvency would be the inevitable or probable result of want of success in the business in which he was engaged."[57] The court reasoned that Doe could not "in this manner provide for himself or his family, and cast upon his creditors the hazard of his speculation."[58] The court set forth a rule: "To invalidate a voluntary conveyance, as against creditors, it is not necessary that the debtor be or believe himself insolvent at the time of the grant; it is sufficient if his solvency is contingent upon the stability of the market in the business in which he is engaged."[59] The risky nature of Roe's business was an important factor in the court's decision, which noted that "poverty or riches [depended] upon the intelligence to be brought by the next steamer."[60] *Carpenter* stands for the proposition that an asset transfer, made without consideration, should not be allowed to shift unfairly the risk of a speculative business enterprise to creditors.

In 1873, twenty-two years after *Carpenter*, the Supreme Court recognized unreasonably small capital as grounds for voiding an asset transfer, even when a debtor was not insolvent.[61] In *Kehr v. Smith*, the Court considered whether a $7,000 marital settlement, paid by the defendant to his estranged wife, constituted a fraudulent conveyance when, after making the payment, his remaining assets were $176 less than

51. *See infra* notes 52–83 and accompanying text. The UFCA was the first known U.S. statute to contain explicit constructive fraud and unreasonably small capital provisions.

52. 10 N.Y. 227 (1851).

53. *Id.* at 228–29.

54. *Id.* at 229.

55. *Id.* at 231.

56. *Id.* at 229.

57. *Id.* at 232.

58. *Id.*

59. *Id.* at 227. Prior to the adoption of the UFCA, other courts followed *Carpenter*'s concept of unreasonably small capital. *See, e.g.*, Brown v. Case, 69 P. 43, 46 (Or. 1902) (a court may set aside a voluntary transfer made without receiving adequate consideration when the debtor's solvency "was contingent upon the stability of the market in the business in which he was engaged."); Hagerman v. Buchanan, 17 A. 946, 948 (N.J. 1889) (engaging in a hazardous or speculative business is presumptively fraudulent if done at the same time or shortly after a voluntary asset transfer).

60. *Carpenter*, 10 N.Y. at 231.

61. Kehr v. Smith, 87 U.S. (20 Wall.) 31 (1873).

his debts.[62] In finding that it was, the Court noted that even if the defendant's estate were worth "a few thousand dollars more," the settlement would still be fraudulent because the extent of the debt "for a person in his situation" would "have a direct tendency to impair the rights of creditors."[63] The Court held that "the rule generally adopted in this country at the present time, will uphold [the marriage settlement] if it be reasonable, not disproportionate to the husband's means, taking into view his debts and situation, and clear of any intent . . . to defraud creditors."[64] In other words, if an asset transfer not meant to defraud creditors results in positive but small remaining net assets,[65] the transfer could be constructively fraudulent depending on the facts and circumstances.[66] As in *Carpenter*, the Court was concerned with risk shifting, but focused on the small amount of remaining net assets (equity cushion), not whether the debtor was engaged in a risky business.[67] An earlier Massachusetts case reached a similar conclusion.[68]

A later case articulated a facts and circumstances-based test for unreasonably small capital that considered both the amount of remaining assets (capital) and riskiness of the debtor's business.[69] In *Hagerman v. Buchanan*, the plaintiff sought to void the defendant's transfer of a house to his wife[70] on the same day he entered into a business partnership.[71] The partnership became insolvent three or four months later.[72] The court noted that "[entering] into a hazardous business . . . or [engaging] in a speculative enterprise, at or soon after the execution of a voluntary conveyance, is strong evidence of a fraudulent intent. It evinces a desire to reap the benefit for himself if successful, and escape responsibility if

62. *Id.* at 31–32.

63. *Id.* at 35.

64. *Id.*

65. Net assets mean assets minus liabilities.

66. The Court noted that the unreliability of asset appraisals was one reason why small remaining net assets (equity) posed a high risk to creditors. *Kehr*, 87 U.S. at 35. ("Meyer was not only largely indebted for a person in his situation, but it is easy to see it would have been close work for his creditors to have made their debts, if they had tried to enforce their collection by judicial process, a surer way of ascertaining the real worth of the property than by the opinions of indifferent persons, as experience has proved that this kind of testimony is often unreliable . . . ."). It is not clear whether the Court is suggesting that asset values are inherently volatile and unpredictable, or that expert witness testimony is suspect (or both).

67. *Id.*

68. Winchester v. Charter, 94 Mass. (12 Allen) 606, 609 (1866) ("[A] voluntary transfer of property by a person deeply indebted, and whose property was . . . barely sufficient for the payment of his debts, would furnish strong presumptive evidence of fraud.").

69. Hagerman v. Buchanan, 17 A. 946, 948 (N.J. 1889). The drafters of the UFCA referred specifically to *Hagerman* in a footnote to section 5. *See* UNIF. FRAUDULENT CONVEYANCE ACT § 5 n.1 (1918), *reprinted in* PROCEEDINGS OF THE TWENTY-EIGHTH ANNUAL MEETING OF THE NAT'L CONFERENCE OF COMM'RS ON UNIF. STATE LAWS 353 (1918).

70. *Hagerman*, 17 A. at 946.

71. *Id.* at 948.

72. *Id.*

unlucky."[73] Nonetheless, the court did not adopt a per se rule,[74] and instead adopted a test that considered the "character of the business, the degree of pecuniary hazard incurred, the amount of property remaining in the grantor, the value of the property conveyed, [and] the acts and words occurring coincidently with the transaction" to determine whether fraudulent intent should be inferred.[75] Put differently, if unreasonably small capital remaining in the transferor is grounds for a fraudulent conveyance, then the hazardous nature of the business should be considered. The court did not void the asset transfer, finding that the defendant did his due diligence and "tried to be careful not to involve himself in a precarious business."[76]

In addition to unreasonably small capital, courts recognized the difference between balance sheet and equity (cash flow) insolvency. In *Potter v. McDowell*, the Missouri Supreme Court said:

> If a debtor is in embarrassed circumstances, and makes a voluntary conveyance, and is afterwards unable to meet his debts owing at the time of the assignment in the ordinary course prescribed by law for their collection, or is reduced to that situation that an execution against him would be unavailing, such conveyance is void as to those debts, and the property conveyed is subject to their payment.[77]

The *Potter* court rejected defining insolvency solely in terms of equity insolvency.[78] In fact, it found it unnecessary to define insolvency at all, and felt that the real issue was identifying what constituted evidence of insolvency.[79] The court appeared to acknowledge the concept of unreasonably small capital when it said "we do not consider that in order to make [a transfer fraudulent as to existing creditors] that the defendant

73. *Id.* The court's language could similarly be used to describe the nature of a leveraged buyout.

74. *Id.* ("[E]ach case must stand on its own footing, and no legal rule can be adopted as to the quantity of proof, or the particular complexity of facts, which will annul a conveyance . . . .").

75. *Id.*; *see also* UNIF. FRAUDULENT CONVEYANCE ACT § 5 n.1 (1918), *reprinted in* PROCEEDINGS OF THE TWENTY-EIGHTH ANNUAL MEETING OF THE NAT'L CONFERENCE OF COMM'RS ON UNIF. STATE LAWS 353 (1918) ("[Fraudulent] 'intent' can be presumed from the nature of the business.").

76. *Hagerman*, 17 A. at 948 ("Mr. Hagerman inquired, as he says he did, particularly about the [partnership's] business . . . .").

77. Potter v. McDowell, 31 Mo. 62, 72–73 (1860) ("Unable to meet his debts owing at the time of the assignment in the ordinary course prescribed . . . for their collection" appears to refer to equity (cash flow) insolvency, and "an execution against him would be unavailing" appears to refer to balance sheet insolvency (assets less than liabilities)).

78. *Id.* at 73 ("We do not adopt the meaning of [insolvency] given it by the English courts in construing the bankrupt laws. There it is said that a man is in insolvent circumstances when he is not in a condition to pay his debts in the ordinary course, as persons carrying on in trade usually do." (internal quotations and citations omitted)).

79. *Id.* ("We do not deem it necessary to define insolvency. We all know what actual insolvency is, but we may differ as to what is the evidence of insolvency."). Although the court deemed it unnecessary to define insolvency, it commented that a better definition than equity insolvency was "if all a man's debts can not be collected by legal process out of his own means." *Id.* The court appears to be embracing a flexible and common sense view of insolvency—e.g., a debtor is insolvent if creditors do not get paid in full.

should have been insolvent at the time of making them."[80]

The concept of unreasonably small capital—developed in *Kehr*, *Potter* and other early cases that focused on the adequacy of equity cushion, but not business risk—is illustrated in *Rose v. Dunklee*.[81] There, the court considered whether a transfer of property from mother to daughter, in consideration of a "very ancient claim" arising from an inheritance, should be voided as fraudulent to creditors.[82] The court described the law as follows:

> Wherever the amount of property so closely approximates the amount of the liabilities that the conveyance would have a direct tendency to impair the rights of creditors if they should attempt to force collection by judicial process, the debtor is adjudged insolvent.... The property which must remain to the debtor after such a transfer must be, as some of the cases put it, clearly and amply sufficient to satisfy his debts; and it is enough in such a case to show that the grantor was embarrassed, and in doubtful circumstances, and his solvency or insolvency may be judged by what happens.[83]

Rose holds that remaining capital is inadequate when it is not "clearly and amply sufficient" to satisfy debts. *Carpenter* and *Hagerman* suggest that business risk should be a factor when determining whether remaining capital is clearly and amply sufficient. And *Potter* suggests that the test of whether remaining capital is clearly and amply sufficient could be prospective balance sheet or equity (cash flow) insolvency. Taken together, these early cases represent a simple framework for analyzing whether a transaction leaves a debtor with unreasonably small capital: an asset transfer is voidable, in the absence of balance sheet or equity insolvency, if it shifts a sufficiently large amount of risk—measured in terms of the underlying business risk, remaining equity cushion, and remaining cash flow cushion—to creditors. Despite the passage of many years, these concepts appear in many contemporary cases involving leveraged buyouts decided under the UFCA, UFTA and Section 548.

3. Uniform Fraudulent Conveyance Act

In 1918, the National Conference of Commissioners on Uniform State Laws (the Conference) adopted the Uniform Fraudulent Conveyance Act (UFCA).[84] The UFCA's goal was to end confusion and uncertainty in then-existing fraudulent conveyance law by defining insolvency, clarifying those persons who have standing, and codifying constructive fraud.[85] The UFCA did not break new legal ground as it

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80. *Id.*

81. 56 P. 342 (Colo. 1899).

82. *Id.* at 342–43.

83. *Id.* at 345.

84. *See* PROCEEDINGS OF THE TWENTY-EIGHTH ANNUAL MEETING OF THE NAT'L CONFERENCE OF COMM'RS ON UNIF. STATE LAWS 348 (1918) (resolution of Aug. 24, 1918 approving the UFCA).

85. *Id.* at 349; *see also id.* at 349–50 ("Need for definite statutory statement does not arise so much

merely restated existing common law.[86] The unreasonably small capital provision is contained in Section 5:

Section 5. [Conveyances by Persons in Business.]

Every conveyance made without fair consideration when the person making it is engaged or is about to engage in a business or transaction for which the property remaining in his hands after the conveyance is an unreasonably small capital, is fraudulent as to creditors and as to other persons who become creditors during the continuance of such business of transaction without regard to his actual intent.[87]

The UFCA does not define unreasonably small capital.[88] The intended meaning of the phrase appears to be taken from the *Carpenter* and *Hagerman* line of cases dealing with hazardous or risky businesses, as is evident from the first draft of Section 5:

Sec. 5. [Conveyances by Persons in Hazardous Business.]

Every conveyance made voluntarily and without a fair consideration, when the person making it is engaged or is about to engage in a hazardous business or transaction involving risks exceeding his remaining assets, is fraudulent as to present creditors and other persons who become creditors as the result of existing but unmatured obligations, or as the result of obligations entered into or acts done during the continuation of such business or transaction.[89]

While the language in the draft is not controlling, it adds insight to the drafters' intended meaning of unreasonably small capital. The draft mentions "*risks* exceeding . . . remaining assets" instead of *liabilities* exceeding remaining assets.[90] The drafters seem to have focused on business risks that might cause future insolvency. The substitution of "unreasonably small capital" for "remaining assets" implies that "unreasonably small capital" likely means something very similar to "unreasonably small remaining assets."[91]

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from actual conflict between the law of different jurisdictions growing out of clear cut differences in judicial decisions, as from confusion of thought manifested in judicial opinions, which renders the law in a great degree uncertain in all jurisdictions. . . . The Chief benefit to be derived from the adoption of the [UFCA] is that . . . it will give a known certainty to the law which it does not now possess."); UNIF. FRAUDULENT CONVEYANCE ACT PREFATORY NOTE, 7A U.L.A. 268 (1999).

86. *See* UNIF. FRAUDULENT CONVEYANCE ACT PREFATORY NOTE (1918), *reprinted in Annual Meeting Proceedings*, 28 NAT'L CONF. COMMISSIONERS ON UNIFORM ST. LAWS 349 (1918) ("The Act as drafted makes few changes in the law of any state.").

87. *Annual Meeting Proceedings*, 28 NAT'L CONF. COMMISSIONERS ON UNIFORM ST. LAWS 353 (1918)) (resolution of Aug. 24, 1918 approving the UFCA) (footnote omitted).

88. Vadnais Lumber Supply, Inc. v. Byrne (*In re* Vadnais Lumber Supply, Inc.), 100 B.R. 127, 137 (Bankr. D. Mass. 1989).

89. UNIF. FRAUDULENT CONVEYANCE ACT § 5 (First Tentative Draft 1916), *reprinted in Annual Meeting Proceedings*, 26 NAT'L CONF. COMMISSIONERS ON UNIFORM ST. LAWS 256 (1916) (footnote omitted).

90. *Id.* (emphasis added).

91. The UFTA, adopted in 1984, substituted "unreasonably small assets" for "unreasonably small capital." *See infra* note 108 and accompanying text.

Twenty-four states and the U.S. Virgin Islands adopted the UFCA.[92] It remains in effect today in New York, Maryland, Wyoming and the U.S. Virgin Islands.[93] Many of the leading cases concerning unreasonably small capital were based on the UFCA.

4. Section 548 of the Bankruptcy Code

The first federal law on fraudulent conveyances was included in section 67(e) of the 1898 Bankruptcy Act.[94] The statute's wording was very similar to the Statute of Elizabeth,[95] but only dealt with actual fraud, not constructive fraud.[96] In 1938, the Chandler Act replaced the 1898 Bankruptcy Act.[97] Its fraudulent conveyance provisions, contained in section 67(d), recognized constructive fraud.[98] The Bankruptcy Code's current fraudulent conveyance provisions are contained in Section 548, which replaced section 67(d) of the Act.[99]

Section 548, derived from the Statute of Elizabeth,[100] contains fraudulent conveyance provisions similar to the UFCA.[101] It was meant to mirror the fraudulent conveyance provisions of the UFCA.[102] Section 548(a)(1) reads:

> The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor voluntarily or involuntarily—
>
> (A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or
>
> (B) (i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and (ii)
>
> (I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
>
> (II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital;

92. UNIF. FRAUDULENT TRANSFER ACT PREFATORY NOTE, 7A U.L.A. 268 (1999).
93. *See* 7A U.L.A. 1 (Supp. 2004) (table of jurisdictions where the UFCA remains in effect).
94. *E.g.*, Pajaro Dunes Rental Agency, Inc. v. Spitters (*In re* Pajaro Dunes Rental Agency, Inc.), 174 B.R. 557, 572 (Bankr. N.D. Cal. 1994).
95. *Id.*
96. *E.g.*, Madrid v. Lawyer's Title Ins. Co. (*In re* Madrid), 725 F.2d 1197, 1200 (9th Cir. 1984).
97. *Pajaro Dunes*, 174 B.R. at 572.
98. *Id.*
99. *See* United States v. Tabor Court Realty Corp., 803 F.2d 1288, 1298 (3d Cir. 1986).
100. Mellon Bank, N.A. v. Metro Commc'ns, Inc., 945 F.2d 635, 644 (3d Cir. 1991).
101. *See Tabor Court Realty*, 803 F.2d at 1298–99.
102. *Id.* at 1299.

> or
>
> (III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.[103]

Like the UFCA, Section 548 does not define unreasonably small capital.[104]

5. *Uniform Fraudulent Transfer Act*

The Conference adopted the UFTA in 1984 as a replacement for the UFCA. It preserved the UFCA's basic structure and approach,[105] but made a number of changes to better correspond to Section 548 and to correct a number of the UFCA's perceived shortcomings.[106] It changed the name of the act from UFCA to UFTA in recognition of the UFTA's applicability to transfers of personal, as well as real property.[107]

The Conference made two important changes to the UFCA's constructive fraud and unreasonably small capital provisions. "Unreasonably small capital" was relabeled "unreasonably small assets" to clarify that "capital" does not have the same meaning in fraudulent conveyance law that it does in corporate law.[108] Under the UFTA, "assets" exclude property to the extent encumbered by valid liens or to the extent exempted under non-bankruptcy law.[109] Section 4(a) of the UFTA reads:

> A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation:
>
> (1) with actual intent to hinder, delay, or defraud any creditor of the debtor; or
>
> (2) without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor:
>
> (i) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or
>
> (ii) intended to incur, or believed or reasonably should have believed that he [or she] would incur, debts beyond his [or

103. 11 U.S.C. § 548(a)(1) (2000).

104. *See* Pajaro Dunes Rental Agency, Inc. v. Spitters (*In re* Pajaro Dunes Rental Agency, Inc.), 174 B.R. 557, 591 (Bankr. N.D. Cal. 1994).

105. UNIF. FRAUDULENT TRANSFER ACT PREFATORY NOTE, 7A U.L.A. 269 (1999).

106. *Id.* at 268.

107. *Id.* at 269.

108. *Id.* at 302–03 ("The reference to 'capital' in the [UFCA] is ambiguous in that it may refer to net worth or to the par value of stock or to the consideration received for stock issued. The special meanings of 'capital' in corporation law have no relevance in the law of fraudulent transfers.").

109. *Id.* at 275, 276.

her] ability to pay as they became due.[110]

II. UNREASONABLY SMALL CAPITAL IN MODERN LAW

A. FRAUDULENT CONVEYANCE LAW

Modern fraudulent conveyance statutes consist of the UFCA and UFTA, as enacted under state law, and Section 548.[111] While each have unreasonably small capital tests, not a single one provides a definition. In interpreting the statutes, courts have dealt with two fundamental issues. First, courts have had to determine the meaning of unreasonably small capital. Second, they have had to determine when a debtor is left with unreasonably small capital.[112]

Moody v. Security Pacific Business Credit, decided in 1992, is one of the leading cases on unreasonably small capital.[113] In *Moody*, the court evaluated whether the failed leveraged buyout of Jeanette Corp., a manufacturer of glassware and other household products, was a fraudulent conveyance under Pennsylvania's version of the UFCA.[114] One of the main issues on appeal was whether the leveraged buyout rendered the company insolvent or left it with unreasonably small capital.[115] The court made two important findings regarding unreasonably small capital, providing both a definition and a test to determine when a debtor has unreasonably small capital. *Moody* has been widely followed by other courts.[116]

First, *Moody* held that unreasonably small capital is a "financial condition short of equitable insolvency."[117] The court noted that in a business setting, "capital is a term of art" and refers to "accumulated

110. *Id.* at 301.

111. Four states—Alaska, Mississippi, South Carolina and Virginia—have not enacted either the UFCA or UFTA. *See* 7A U.L.A. 1, 26 (Supp. 2004) (tables of jurisdictions where the UFCA and UFTA are in effect). In Virginia, recovery of property is limited to cases of actual fraud, not constructive fraud. *In re* Best Prods. Co., 168 B.R. 35, 52 (Bankr. S.D.N.Y. 1994).

112. Small capital or assets (undercapitalization) is a common sense notion. The difficult question is determining when small capital or assets becomes unreasonably small.

113. 971 F.2d 1056, 1070 (3d Cir. 1992).

114. *Id.* at 1059, 1063. The District Court found it unnecessary to separately consider whether the transaction constituted a fraudulent conveyance under Section 548 because its fraudulent conveyance provisions "are modeled after and typically interpreted in conjunction with those of the UFCA" and "it follows that if the leveraged buyout is not fraudulent under the UFCA, it is not fraudulent under § 548 of the Bankruptcy Code." *Id.* at 1062 n.5. Pennsylvania replaced the UFCA with the UFTA in 1993. *See* 7A U.L.A. 26 (Supp. 2004) (table of jurisdictions that have adopted the UFTA).

115. *Moody*, 971 F.2d at 1062, 1065. The court noted, without debate, that the UFCA applied to leveraged buyouts. *Id.* at 1058 (The "Pennsylvania Uniform Fraudulent Conveyance Act (UFCA) extends to leveraged buyouts.").

116. *See infra* note 139.

117. *Moody*, 971 F.2d at 1070. Equitable insolvency, sometimes referred to as cash flow insolvency, is a financial condition where a company is unable to pay its debts as they come due. *See* Queenan, *infra* note 119, at 13.

goods, possessions, and assets, used for the production of profits and wealth."[118] Therefore, the court reasoned, unreasonably small capital refers to an "inability to generate sufficient profits to sustain operations," and "[b]ecause an inability to generate enough cash flow to sustain operations must precede an inability to pay obligations as they become due, unreasonably small capital would seem to encompass financial difficulties short of equitable insolvency."[119] In short, the court held that unreasonably small capital means just barely equitably (cash flow) solvent. The court rejected another leading view of unreasonably small capital, which per se equates a finding of equitable insolvency with that of unreasonably small capital.[120]

An important unanswered question in *Moody* is why the court viewed unreasonably small capital as a financial condition short of equitable insolvency instead of either equitable *or* balance sheet insolvency. Earlier cases written by Judge Queenan and cited in *Moody* followed the broader view.[121] The *Moody* court's argument is similar to Judge Queenan's 1989 article (concluding that unreasonably small capital

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118. *Moody*, 971 F.2d at 1070 (internal quotations omitted) (quoting Black's Law Dictionary 189 (5th ed. 1979)).

119. *Id. Contra* James F. Queenan, Jr., *The Collapsed Leveraged Buyout and the Trustee in Bankruptcy*, 11 CARDOZO L. REV. 1, 18 (1989) ("Unreasonably small capitalization encompasses financial difficulties which are short of equitable or bankruptcy insolvency . . . ."). Bankruptcy insolvency, sometimes referred to as balance sheet insolvency, is a financial condition where assets (at a fair valuation) are less than liabilities. *See* Stillwater Nat'l Bank and Trust Co. v. Kirtley (*In re* Solomon), 299 B.R. 626, 638 (B.A.P. 10th Cir. 2003).

120. *Moody*, 971 F.2d at 1070. The court noted that if the drafters of the UFCA had viewed equitable insolvency and unreasonably small capital interchangeably, it would have expected them to use the same language in sections 4 and 5. *Id.* The view that a finding of equitable insolvency means unreasonably small capital per se has deep historical roots. *See, e.g.*, Rose v. Dunklee, 56 P. 342, 345 (Colo. 1899) ("The property which must remain to the debtor after such a transfer must be . . . clearly and amply sufficient to satisfy his debts . . . and his solvency or insolvency may be judged by what happens."). The per se rule was criticized in Bruce A. Markell, *Toward True and Plain Dealing: A Theory of Fraudulent Transfers Involving Unreasonably Small Capital*, 21 IND. L. REV. 469, 492–95 (1988). In preparing this Note, I did not identify any reported cases in the past ten years that relied on the per se theory.

121. *See* Murphy v. Meritor Sav. Bank (*In re* O'Day Corp.), 126 B.R. 370, 407 (Bankr. D. Mass. 1991) (Queenan, J.) ("[U]nreasonably small capitalization encompasses financial difficulties which are short of equitable insolvency or bankruptcy insolvency . . . ." (quoting Queenan, *supra* note 119, at 18) (internal quotations omitted)); Vadnais Lumber Supply, Inc. v. Byrne (*In re* Vadnais Lumber Supply, Inc.), 100 B.R. 127, 137 (Bankr. D. Mass. 1989) (Queenan, J.) ("Unreasonably small capital . . . encompasses difficulties which are short of insolvency in *any* sense. . . ." (emphasis added)); *Moody*, 971 F.2d at 1070 n.20 (quoting *Murphy* and *Vadnais Lumber Supply* in support of *Moody*'s statement that "others have said that unreasonably small capital encompasses financial difficulties short of equitable insolvency," *id.* at 1070). Despite the court's reliance on *Murphy* and *Vadnais Lumber Supply*, these cases do not appear to support this statement. Further, Judge Queenan's opinion in *Murphy* (quoted in *Moody*) misquoted his earlier article. *Compare Murphy*, 126 B.R. at 407 ("financial difficulties . . . short of equitable insolvency or bankruptcy insolvency"), *with* Queenan, *supra* note 119, at 18 ("financial difficulties . . . short of equitable or bankruptcy insolvency"). It is not clear whether this minor error in *Murphy* influenced *Moody*'s oft-repeated holding that "unreasonably small capital denotes a financial condition short of equitable insolvency." *Moody*, 971 F.2d at 1070.

is a financial condition short of equitable or balance sheet insolvency),[122] but comes to a different conclusion.[123] Later cases have largely followed *Moody*'s cash flow-based definition of unreasonably small capital.[124]

Judge Queenan, however, expanded his earlier analysis applied in *O'Day* and equated unreasonably small capital with the risk, not likelihood, of insolvency. In *Brandt v. Hicks, Muse & Co.*, the court considered whether directors should be held liable for breach of fiduciary duty by approving an LBO that left the debtor insolvent or with unreasonably small capital.[125] In Judge Queenan's decision, the court equated unreasonably small capital with an unreasonable risk of insolvency.[126] It compared unreasonable risk of insolvency with negligence, "which is conduct that creates an unreasonable risk of harm" to others.[127]

Second, *Moody* held that the test for unreasonably small capital is "reasonable foreseeability" and the critical issue is whether the financial projections prepared by the parties to the LBO were reasonable.[128] The reasonableness of cash flow projections test originated in *Credit Managers Ass'n v. Federal Co.*[129] In *Credit Managers*, the court began its unreasonably small capital analysis by noting that the outcome should consider the facts and circumstances on a case-by-case basis, an expansive view embraced by other courts.[130] In determining that the

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122. *Compare Moody*, 971 F.2d at 1070, *with* Queenan, *supra* note 119, at 17–18.

123. *Compare Moody*, 971 F.2d at 1070 (equitable insolvency), *with* Queenan, *supra* note 119, at 18 (equitable or balance sheet insolvency).

124. *See, e.g.*, Ring v. Bergman (*In re* Bergman), 293 B.R. 580, 584 (Bankr. W.D.N.Y. 2003); Peltz v. Hatten, 279 B.R. 710, 744–45 (Bankr. D. Del. 2002); Geron v. Schulman (*In re* Manshul Constr. Corp.), 97 Civ. 8851, 99 Civ. 2825, 2000 U.S. Dist. LEXIS 12576, at *154 (Bankr. S.D.N.Y. Aug. 30, 2000); MFS/Sun Life Trust v. Van Dusen Airport Servs. Co., 910 F. Supp. 913, 944 (S.D.N.Y. 1995); *In re* Best Prods. Co., 168 B.R. 35, 54 (Bankr. S.D.N.Y. 1994) (The focus on the reasonableness of projections used to justify a transaction is a "trend.").

125. Brandt v. Hicks, Muse & Co. (*In re* Healthco Int'l, Inc.), 208 B.R. 288, 293, 301 (Bankr. D. Mass. 1997). The case was based on a theory of director liability in the zone of insolvency rather than fraudulent conveyance. *Id.* at 301. The court utilized the definition of unreasonably small capital under fraudulent conveyance law. *Id.* at 302.

126. *Id.* ("[Unreasonably small capital] connotes a condition of financial debility short of insolvency (in either the bankruptcy or equity sense) but which makes insolvency reasonably foreseeable. In other words, a transaction leaves a company with unreasonably small capital when it creates an unreasonable risk of insolvency, not necessarily a likelihood of insolvency.").

127. *Id.*

128. *Moody*, 971 F.2d at 1073 ("The critical question is whether the parties' projections were reasonable."). The reasonableness test is presumably applied to projections showing that the company is equitably solvent (e.g., able to pay its debts as they mature). *See id.* at 1071 ("[D]efendants' decision to enter into the [transaction] challenged here was predicated on their projections *that the acquisition would succeed* . . . ." (emphasis added)).

129. Credit Managers Ass'n of S. Cal. v. Fed. Co., 629 F. Supp. 175, 182 (C.D. Cal. 1985).

130. *Id.* at 183 ("Whether [debtor] was undercapitalized . . . is a 'question of fact that must be ascertained on a case by case basis.'" (quoting Wells Fargo Bank v. Desert View Bldg. Supplies, Inc. (*In re* Desert View Bldg. Supplies, Inc.), 475 F. Supp. 693, 697 (D. Nev. 1978), *aff'd* 633 F.2d 225 (9th

reasonableness of the cash flow projections in this case was probative of unreasonably small capital, the court relied heavily on the expert testimony of a regional manager of General Electric Credit Corp. (GECC).[131] The witness testified that "projected cash flow . . . is among the most important factors [GECC] consider[s,]" while assets are less important.[132] The court reasoned that the pertinent question was whether "GECC's projection . . . was reasonable and prudent at the time it was made," and found that it was.[133]

In determining whether the forecasts were reasonable, the *Moody* court held that they "must be tested by an objective standard anchored in the company's actual performance" (e.g., whether they were consistent with the company's prior financial performance).[134] In *Pajaro Dunes*, the court evaluated "reasonable" in terms of whether the information used by the parties to prepare the forecasts were "flawed and overly optimistic from the beginning."[135] In addition to consistency with historical results, the forecasts must "incorporate some margin for error."[136] This forward-looking approach can be viewed as a cash flow cushion test.[137] In order to have enough cushion, the forecasts should allow for reasonably foreseeable difficulties that could arise.[138] Later cases have widely followed *Moody* and *Credit Managers'* cash flow reasonableness test.[139]

Cir. 1980))); *see also* Yoder v. T.E.L. Leasing, Inc. (*In re* Suburban Motor Freight, Inc.), 124 B.R. 984, 998 (Bankr. S.D. Ohio 1990) (the meaning of unreasonably small capital "must . . . be ascertained upon a case-by-case review of the capital structure of a debtor's business.").

131. *Credit Managers*, 629 F. Supp. at 183 ("The testimony of GECC's [regional manager] is especially probative" in concluding that the debtor "was not undercapitalized at the time of the buyout.").

132. *Id.*

133. *Id.* at 184.

134. Moody v. Sec. Pac. Bus. Credit, 971 F.2d 1056, 1073 (3d Cir. 1992). Relevant historical data include cash flow, net sales, gross profit margin and net profits and losses. *Id.* In addition, the projections must consider reasonably foreseeable difficulties that might arise, including "interest rate fluctuations and general economic downturns," and "otherwise incorporate some margin for error." *Id.*

135. Pajaro Dunes Rental Agency, Inc. v. Spitters (*In re* Pajaro Dunes Rental Agency, Inc.), 174 B.R. 557, 593 (Bankr. N.D. Cal. 1994).

136. *Moody*, 971 F.2d at 1073. Examples of difficulties that are likely to arise include "interest rate fluctuations and general economic downturns." *Id.*

137. The *Moody* court evaluated capital sufficiency in terms of whether the financial projections were reasonable. One of the principal concerns was whether there was enough margin for error in the projections. Since financial projections by themselves cannot determine whether a company is solvent, the court was really asking whether the financial projections used in the LBO showed there was sufficient cash flow to pay the company's debts as they came due, were reasonably prepared and credible, and contained sufficient margin for error. In essence, the *Moody* test boils down to whether a company has enough "cushion" in its financial (cash flow) projections to withstand reasonably foreseeable events and still pay its debts as they come due.

138. *See supra* note 134. Conceptually, the *Moody* approach is consistent with the intentions of the UFCA's drafters and the common law that the remaining capital should be proportionate to the risky or hazardous nature of the particular business. *See supra* notes 52–90 and accompanying text.

139. *See, e.g.*, Ring v. Bergman (*In re* Bergman), 293 B.R. 580, 584 (Bankr. W.D.N.Y. 2003); Peltz

In applying the reasonableness test, a number of issues arise, including the amount of time over which to analyze projected cash flows and whether it is appropriate to consider debt financing, equity financing, or asset sales as sources of cash. Generally, courts have held that companies do not have unreasonably small capital if they survive for an "extended period" of time—up to one year.[140] A business can fail for many other reasons beside inadequate capital, and presumably the longer the time period before failure, the greater the chance the business failed for other reasons, making causation more difficult to establish. A recent case upheld a three-year period as appropriate for cash flow analysis, based on the nature of the debtor's business (a holding company).[141] It does make sense to fix a time period over which to draw conclusions. However, the time period ought to be sufficient to determine whether the alleged undercapitalization caused the company to default on its obligations.[142]

"Cash flow" generally consists of cash from operations,[143] plus proceeds from debt financing, equity financing and asset sales. Courts have considered each of these sources of cash in analyzing unreasonably small capital. They are divided on whether future borrowing, from established lines of credit or otherwise, should count.[144] Although additional equity financing may be a speculative and unreliable source of cash, at least one court allowed it.[145] In *Peltz v. Hatten*, the court found

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v. Hatten, 279 B.R. 710, 744–45 (Bankr. D. Del. 2002); WRT Creditors Liquidation Trust v. WRT Bankr. Litig. Master File Defendants (*In re* WRT Energy Corp.), 282 B.R. 343, 411 (Bankr. W.D. La. 2001); Brandt v. Hicks, Muse & Co. (*In re* Healthco Int'l, Inc.), 195 B.R. 971, 981 (Bankr. D. Mass. 1996) ("[U]nreasonably small capital typically depends upon the reasonableness of the parties' projections."). *But see* Brandt v. Hicks, Muse & Co., Inc. (*In re* Healthco Int'l, Inc.), 202 B.R. 288, 302 (Bankr. D. Mass. 1996) (unreasonably small capital connotes a financial debility short of equity or bankruptcy insolvency).

140. *See* Daley v. Chang (*In re* Joy Recovery Tech. Corp.), 286 B.R. 54, 76 (Bankr. N.D. Ill. 2002) (noting other cases where courts did not find unreasonably small capital when creditors were paid eight to twelve months after asset transfers). *But see infra* note 141 and accompanying text (three-year time horizon appropriate).

141. Pereira v. Cogan, 294 B.R. 449, 510 (Bankr. S.D.N.Y. 2003) ("[A] three-year horizon is appropriate for evaluation of the cash flow and capital adequacy of a holding company such as [the debtor].").

142. *See* Markell, *supra* note 120, at 504–05 (discussing the need for a direct and causal link between an asset transfer and non-payment of creditors).

143. Cash flow from operations could include profits or losses. Proceeds from debt financing, equity financing and asset sales could, in theory, supplement low cash flow or make up for negative cash flow.

144. *Compare* Moody v. Sec. Pac. Bus. Credit, Inc., 971 F.2d 1056, 1072–73 (3d Cir. 1992) (borrowing is a factor in testing for unreasonably small capital), and VFB LLC v. Campbell Soup Co., No. 02-137, 2005 U.S. Dist. LEXIS 19999, at *106 (D. Del. Sept. 13, 2005) ("When considering if a business is inadequately capitalized, it is proper to consider the availability of credit."), *with* Murphy v. Mentor Sav. Bank (*In re* O'Day Corp.), 126 B.R. 370, 408 (Bankr. D. Mass. 1991) (rejecting borrowing as a source of cash flow for unreasonably small capital test).

145. Peltz v. Hatten, 279 B.R. 710, 745 (Bankr. D. Del. 2002).

that a formerly high flying but money-losing telecommunications company, USN Communications, did not have unreasonably small capital because, in part, the company had the ability to raise considerable additional debt and equity capital.[146] When combined with considerable cash-on-hand, there would have been sufficient financial resources to fund its high-growth, cash-consuming business strategy.[147] The court noted that if the company perceived it would not have access to additional capital, it could scale back its operations.[148] Asset sales are another source of cash accepted by courts.[149] Key issues are whether the assets to be sold are "core assets" critical to the cash-flow generating capabilities of the rest of the business,[150] the feasibility of sales, timing and valuation. Some courts and commentators have advocated a broad definition of cash flow, to include cash from all sources.[151]

Although the *Moody* framework appears to be the majority view on unreasonably small capital, other approaches have been followed. Some courts have looked at financial ratios, historic need for working capital, and industry comparisons.[152] Some have looked at other factors and tests.[153] In every case, the goal is the same: courts want to identify those

146. *Id.* at 745–47.

147. *Id.*

148. *Id.* at 747. The company filed for bankruptcy after the capital markets unexpectedly dried up and the company failed to scale back its operations until after it was too late. *Id.* at 747–48. Arguably, both events (collapse in the availability of financing for money-losing technology companies and management mistakes grounded in over optimism) were reasonably foreseeable. Although the court did not find the debtor to have unreasonably small capital, this case highlights the need to be cautious about relying on debt or equity financing as a source of cash to pay creditors.

149. *See* Vadnais Lumber Supply, Inc. v. Byrne (*In re* Vadnais Lumber Supply, Inc.), 100 B.R. 127, 137 (Bankr. D. Mass. 1989) ("The courts have applied the fraudulent transfer concept by looking to the ability of the debtor to generate enough cash from operations or asset sales to pay its debts and still sustain itself."); Salisbury v. Tex. Commerce Bank, N.A. (*In re* WCC Holding Corp.), 171 B.R. 972, 985 (Bankr. N.D. Tex. 1994) ("Unreasonably small assets signifies an inability to generate enough cash flow from operations and the sale of assets to remain financially stable.").

150. *See, e.g.*, Jacobsen v. First State Bank of Benson, 48 B.R. 497, 501 (Bankr. D. Minn. 1985) (unreasonably small capital depends on whether transferred property was "necessary to the continued operation of the . . . business."); STANDARD & POOR'S, INC., 2005 CORPORATE RATINGS CRITERIA 32 (2005) ("As going concerns, companies should not be expected to repay debt by liquidating operations.").

151. *See* Markell, *supra* note 120, at 496.

152. *See* Daley v. Chang (*In re* Joy Recovery Tech. Corp.), 286 B.R. 54, 76 (Bankr. N.D. Ill. 2002); Geron v. Schulman (*In re* Manshul Constr. Corp.), 97 Civ. 8851, 99 Civ. 2825, 2000 U.S. Dist. LEXIS 12576, at *154 (Bankr. S.D.N.Y. Aug. 30, 2000); MFS/Sun Life Trust v. Van Dusen Airport Servs. Co., 910 F. Supp. 913, 944 (S.D.N.Y. 1995).

153. *See, e.g.*, Diller v. Irving Trust Co., 62 F.2d 1058 (2d Cir. 1933) (encumbering all assets is unreasonably small capital per se); Yoder v. T.E.L. Leasing, Inc. (*In re* Suburban Motor Freight, Inc.), 124 B.R. 984, 999 (Bankr. S.D. Ohio 1990) (weigh financial data against nature of the entity and its need for capital); Wells Fargo Bank v. Desert View Bldg. Supplies, Inc. (In the Matter of Desert View Bldg. Supplies, Inc.), 475 F. Supp. 693, 697 (D. Nev. 1978), *aff'd* 633 F.2d 225 (9th Cir. 1980) (relationship between the debtor and its creditors before and after the transfer and considering whether debtor was able to obtain credit on normal terms); Zuk v. Hale, 330 A.2d 448, 451 (N.H.

facts and circumstances indicating that the debtor has an unreasonably high risk of defaulting on its obligations to creditors.[154]

B. UNREASONABLY SMALL CAPITAL AND THE ZONE OF INSOLVENCY

The concept of unreasonably small capital is similar to the "zone of insolvency." Directors of a solvent corporation owe fiduciary duties to the corporation and its shareholders, but not to creditors.[155] Creditors are protected by their contractual relationship with the corporation.[156] Courts have found, however, that when a corporation enters the "zone" or "vicinity" of insolvency the duties of the directors may shift from shareholders to creditors.[157] The "zone" is a risky financial condition short of insolvency.[158] Therefore, the standard for determining when a corporation enters the zone of insolvency may be instructive in determining when there is unreasonably small capital. In *Pereira v. Cogan*, the court utilized the Moody cash flow cushion test to determine that the debtor in question was insolvent or in the vicinity of insolvency.[159] *Pereira* is the primary zone of insolvency case that attempts to determine when a company is in the zone.[160]

An important difference between unreasonably small capital and the

1974) (total working capital for the type of business).

154. *Cf.* Brandt v. Hicks, Muse & Co., Inc. (*In re* Healthco Int'l, Inc.), 208 B.R. 288, 302 (Bankr. D. Mass. 1997) ("A transaction leaves a company with unreasonably small capital when it creates an *unreasonable risk* of insolvency, not necessarily a likelihood of insolvency." (emphasis added)).

155. *See, e.g.*, United States v. Jolly, 102 F.3d 46, 48 (2d Cir. 1996) ("[A] firm's obligations to creditors" are solely contractual). Nor do directors owe fiduciary duties to holders of convertible debt, which have characteristics of debt and equity. *See, e.g.*, Simons v. Cogan, 549 A.2d 300, 302–04 (Del. 1988) (directors do not have fiduciary duties to holders of convertible debt absent fraud, insolvency or other special circumstances); Lorenz v. CSX Corp., 1 F.3d 1406, 1417 (3d Cir. 1993) (corporation does not owe fiduciary duties to creditors); Steinberg v. Kendig (*In re* Ben Franklin Retail Stores, Inc.), 225 B.R. 646, 652 (Bankr. N.D. Ill. 1998) ("Under Delaware law, directors of solvent corporations owe fiduciary duties to shareholders, but not to creditors.").

156. *See Steinberg*, 225 B.R. at 652–53 ("Creditors ... deal with corporations by entering into contracts. Satisfaction of their claims ... requires only compliance with their contracts. So long as the corporation is solvent, they require no additional protection; by definition, a solvent corporation, no matter how badly managed ..., is able to satisfy its contractual obligations.").

157. *See* Carrieri v. Jobs.com, Inc., 393 F.3d 508, 534 n.24 (5th Cir. 2004) ("[W]hen a corporation reaches the 'zone of insolvency,' ... the officers and directors have an expanded fiduciary duty to all creditors of the corporation, not just the equity holders."). *But see* Adelphia Commc'ns Corp. v. Rigas (*In re* Adelphia Commc'ns Corp.), 323 B.R. 345, 386 n.140 (Bankr. S.D.N.Y. 2005) ("[D]irectors' obligations are to the firm itself.") (citing Prod. Res. Group, L.L.C., v. NCT Group, Inc., 863 A.2d 772, 791 (Del. Ch. 2004)); *Prod. Res. Group*, 863 A.2d at 772, 776–77, 786–91 (stating that directors do not owe a fiduciary duty to creditors when the corporation is in the zone of insolvency).

158. *See Prod. Res. Group*, 863 A.2d at 789–90 n.56.

159. 294 B.R. 449, 509–11 (Bankr. S.D.N.Y. 2003).

160. *See* Corinne Ball, *Distressed Mergers and Acquisitions; Creditors' Claims Against Directors*, N.Y. L.J., Feb. 24, 2005, at 5. *But see* U.S. Bank Nat'l Ass'n v. U.S. Timberlands Klamath Falls, L.L.C., 864 A.2d 930, 948 (Del. Ch. 2004), *vacated on other grounds*, No. 36, 2005 Del. LEXIS 215 (Del. June 6, 2005) ("While the so-called zone of insolvency has not been clearly defined, it is clear that whether a company is within the zone can be a fact-intensive inquiry.").

zone of insolvency is how the corporation gets there. If the corporation enters the zone of insolvency because of a voluntary asset transfer made without receiving reasonably equivalent value (i.e., as a result of a leveraged buyout), the transaction is a voidable fraudulent conveyance and the directors may be liable. If the corporation enters the zone of insolvency for other reasons (i.e., because of losses not attributable to a breach of directors' fiduciary duties) the directors are not liable.[161] In either case, once in the zone, directors may be liable for violations of their possible fiduciary duties to creditors, or for initiating fraudulent asset transfers.[162] Unlike fiduciary duty, there is no standard of care applicable to a fraudulent conveyance: it is per se voidable.

III. Proposed Framework For Analysis

A. General Approach

The majority case law on unreasonably small capital, led by *Moody*, does not provide an adequate method for determining when a transfer leaves a company with unreasonably small capital. The purpose of the unreasonable capital test of constructive fraud is to protect creditors from an unreasonable risk of loss caused by asset transfers that leave a company barely solvent. In such a position, shareholders have little to lose and much to gain, while creditors have much to lose and little to gain.

Moody's cash flow cushion test is only a partial solution. Even if unreasonably small capital is a financial condition short of equity insolvency, equity (balance sheet) cushion is equally as important as cash flow cushion.[163] If cash flow is insufficient to pay debts as they come due (equity insolvency), a company may be able to pay its debts by selling some or all of its assets, provided there is enough time and enough equity cushion. The ability of a company to sell assets to pay creditors in full depends on the fair saleable value of the assets[164] and the amount of

161. Directors do not become liable simply because a corporation enters the zone of insolvency. They are still subject to their duties of due care, good faith and loyalty to the corporation and its shareholders (before entering the zone of insolvency) and to the corporation and its creditors (after entering into the zone of insolvency).

162. An asset transfer made for inadequate consideration when a corporation is in the zone of insolvency could arguably be both a fraudulent conveyance and a violation of the directors' fiduciary duties.

163. *See, e.g.*, Pajaro Dunes Rental Agency, Inc. v. Spitters (*In re* Pajaro Dunes Rental Agency, Inc.), 174 B.R. 557, 591 (Bankr. N.D. Cal. 1994) (criticizing the cash flow cushion test) ("[The cash flow cushion] analysis tends to blur the lines between the [unreasonably small capital] and [cash flow] tests.... The tests can be distinguished through the use of the balance sheet approach in the [unreasonably small capital] analysis ....").

164. *See, e.g.*, Queenan, *supra* note 119, at 14 ("Some... decisions construe the phrase 'fair saleable value'... to exclude the value of illiquid assets which cannot be sold in sufficient time to pay debts as they mature ...."). Fair saleable value is the appropriate standard, rather than theoretical fair

liabilities. As with cash flow, there needs to be adequate cushion or margin for error for reasonably foreseeable adverse events that could impact asset values or the ability to sell assets.[165] On the other hand, if a company is able to pay its debts as they come due (is equitably solvent), balance sheet insolvency is largely irrelevant for purposes of unreasonably small capital, unless the company is compelled to sell or liquidate for contractual or other reasons. Under *Moody*'s definition of unreasonably small capital, the unreasonably small capital test should be whether there is sufficient cash flow cushion or equity cushion. Under the *Brandt* definition of unreasonably small capital, the test should be whether there is sufficient cash flow cushion *and* equity cushion.[166]

Analysis of equity and cash flow cushion does not go far enough. Under *Brandt*, unreasonably small capital means an unreasonable risk of insolvency.[167] Since fraudulent conveyance laws are intended to protect creditors from losses caused by unfair asset transfers,[168] it makes no sense to confine the meaning of "insolvency" to its legal definition.[169] There is also no need to do so, because unreasonably small capital is not defined by statute.[170] Further, the statutes' unreasonably small capital provisions make no reference at all to "insolvency."

A better approach is to equate unreasonably small capital with an unreasonable risk of loss to creditors.[171] In addition to the cash flow and equity cushion tests, courts should look at all other facts and circumstances to determine whether an asset transfer (made for less than reasonably equivalent value) results in an unreasonable risk of loss to creditors.[172] The question then becomes how to determine when the risk of loss becomes unreasonable. One way of doing so is to follow the same approach used by creditors in determining whether to extend credit.[173] In

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market value, because creditors will only be paid in full if the actual sales price for the assets equals or exceeds liabilities.

165. *Cf.* Moody v. Sec. Pac. Bus. Credit, Inc., 971 F.2d 1056, 1073 (3d Cir. 1992).

166. Judge Queenan's definition of unreasonably small capital, used in *Brandt*, is when a company is in a weakened financial condition short of balance sheet or equity insolvency but where insolvency is reasonably foreseeable. Brandt v. Hicks, Muse & Co., Inc. (*In re* Healthco Int'l, Inc.), 208 B.R. 288, 302 (Bankr. D. Mass. 1997); Queenan, *supra* note 119, at 18. Under this definition, a company has unreasonably small capital if it is balance sheet insolvent, even if is equitably solvent.

167. *See Brandt*, 208 B.R. at 302.

168. For purposes of this Note, an unfair asset transfer refers to a transfer where a corporation does not receive reasonably equivalent value. Often, such a transfer will also not be entirely fair to the corporation.

169. *E.g.*, equitable and balance sheet insolvency.

170. *Brandt*, 208 B.R. at 302.

171. *Cf.* Zaretsky, *supra* note 16, at 1172–76 (fraudulent conveyance laws serve to restrain companies from taking unreasonable risks with assets that otherwise might be available to creditors, a purpose not originally contemplated when the laws were promulgated).

172. Presumably, courts will continue to utilize the parties' own expert testimony in analyzing unreasonably small capital, rather than conduct its own credit analysis.

173. Creditors and ratings agencies are likely better at analyzing credit risk than courts.

fact, an unreasonable risk of loss may be viewed as a condition under which a creditor, dealing on arm's length terms, would no longer be willing to extend credit.[174] A review of how credit rating agencies evaluate undercapitalization and credit risk identifies those facts and circumstances that may indicate an unreasonably high level of risk of loss, and therefore the presence of unreasonably small capital.

B. Risk Analysis in the Marketplace

Unreasonably small capital and credit risk may be a vexing problem for the courts, but not the private sector. Creditors and analysts have developed elaborate methodologies for evaluating a prospective debtor's creditworthiness and the risk faced by creditors. Insight into factors that contribute to a company's credit quality, risk of default and risk of loss can be gleaned from organizations such as Standard & Poor's (S&P) and Moody's Investors Service (Moody's)[175] that issue credit ratings on companies, bonds, bank loans, and other debt instruments. S&P's overall rating methodologies shed light on the relative importance of cash flow and equity cushion. Moody's criteria for assigning its lowest ratings categories is particularly insightful into understanding what constitutes unreasonably small capital.

S&P rates companies' (issuers') creditworthiness based on financial, company and industry criteria.[176] Long-term issuer ratings range from D (weakest) to AAA (strongest).[177] A CCC rating is highly speculative,[178] potentially indicative of unreasonably high risk.[179] When rating an issuer, cash-flow analysis is the single most important, but not only, factor.[180]

174. *See, e.g.*, Mach. Car Rental, Inc. v. Herpel (In the Matter of Multiponics, Inc.), 622 F.2d 709, 717 (5th Cir. 1980) ("Capitalization is inadequate if . . . the bankrupt could not have borrowed a similar amount of money from an informed outside source.") (citing Benjamin v. Diamond (In the Matter of Mobile Steel Co.), 563 F.2d 692, 703 (5th Cir. 1977)). *Multiponics* dealt with undercapitalization in connection with equitable subordination and alter ego actions, while *Mobile Steel* dealt with equitable subordination.

175. Moody's Investors Service is unrelated to the plaintiff Moody in *Moody v. Security Pacific Business Credit, Inc.*, 971 F.2d 1056 (3d Cir. 1992).

176. *See* Standard & Poor's, Inc., 2005 Corporate Ratings Criteria 8–9, 19 (2005).

177. *Id.* at 8. An issuer rating is based on the overall credit risk of the company as compared to a rating on a specific security or issue.

178. *Id.* at 12 ("An obligation rated 'CCC' currently is vulnerable to nonpayment and is dependent on favorable business, financial and economic conditions for the obligor to meet its financial commitment on the obligation. In the event of adverse business, financial, or economic conditions, the obligor is not likely to have the capacity to meet is financial commitment on the obligation.").

179. S&P's description of a CCC rating (obligor not likely to meet financial commitment in the event of adverse conditions) seems similar to *Moody*'s rationale for requiring a debtor to have adequate margin for error. *See* Moody v. Sec. Pac. Bus. Credit, Inc., 971 F.2d 1056, 1073 (3d Cir. 1992). S&P's CCC rating is equivalent to Moody's Caa rating, which is assigned when the issuer is "seriously undercapitalized relative to its outstanding debt . . . and business risk" and its "equity base is unreasonably thin." Moody's Investors Service Global Credit Research, Special Comment: Credit Considerations in Assigning a Caa1 1, 4, 8 (1999).

180. Standard & Poors, Inc., *supra* note 176, at 29 ("Cash-flow analysis is the single most critical

Other factors include business risk, industry risk (including cyclicality), size and diversification, management, organizational culture, accounting characteristics and information risk, financial policies, profitability, interest and cash-flow coverage, capital structure, leverage, asset protection and asset valuation.[181] When rating issuers, S&P will vary the importance of each factor depending on the circumstances.[182] For an issuer strong in one area and weak in another, S&P will balance the factors.[183] S&P issuer ratings focus on the likelihood of default.[184]

In addition, S&P rates bank loans and other secured obligations.[185] While issuer ratings focus on the likelihood of default,[186] bank loan ratings focus on likelihood of default *and* expected recovery (loss) on the bank loan in the event of a default.[187] S&P also issues a separate recovery rating, that only addresses recovery prospects—the likelihood of default is irrelevant.[188] When rating bank loans, default scenarios (i.e., was the reason for the default due primarily to excess leverage or underlying business weakness) and asset values are important.[189]

When valuing assets, S&P will often value the entire business enterprise if the business' operating assets are part of the security package (i.e., the collateral is a going-concern business).[190] An important determinant in deciding whether to value the overall business as a going-concern is the likely nature of any default.[191] If a default is likely due primarily to high leverage, S&P will tend to value the business as a going-concern.[192] Going-concern valuations are based on expected values at the time of default (considering the likely decline in earnings that cause the

aspect of all credit rating decisions. *It takes on added importance for speculative grade issuers.*" (emphasis added)). When analyzing the sufficiency of cash flow, S&P considers the amount of cash flow available relative to debt service and other cash requirements, future working capital and capital expenditure needs, flexibility to alter the timing of capital requirements, financial flexibility (access to capital markets or ability to restructure existing obligations) and liquidity. *Id.* at 29–32.

181. *Id.* at 19–29.

182. *See id.* at 19.

183. *See id.*

184. *See id.* at 11 ("[I]ssuer . . . rating definitions are expressed in terms of default risk . . . .").

185. *Id.* at 62.

186. *See supra* note 184.

187. STANDARD & POORS, INC., *supra* note 176, at 64 ("The starting point for assigning a bank loan rating is determining the borrower's default risk. . . . The analysis then proceeds to the recovery aspects of a specific debt issue.").

188. *Id.* ("[R]ecovery ratings . . . purely address the recovery prospects, the likelihood of default is irrelevant.").

189. *See id.* at 65–69. Recovery on a bank loan can depend on the way a company defaults. If a company defaults because of excess leverage, secured lenders may achieve a high level of recovery if asset values are otherwise unaffected. Underlying weakness or excessive volatility in the business or economy overall could negatively impact asset values, resulting in a lower amount of recovery.

190. *See id.* at 66–67.

191. *See id.* at 67.

192. *Id.*

default), not when the rating is issued.[193] Otherwise, it will look to the liquidation values of individual assets such as in the case of a company with a weak underlying business.[194] S&P's asset valuation methodology—focusing on the asset's likely value in default—appears to be more consistent with the practical nature of "fair saleable value" than the theoretical nature of "fair market value."

Moody's Investors Service, another ratings agency, uses a similar approach to that of S&P.[195] Its criteria for assigning a Caa1 rating is particularly instructive in determining when a debtor may be left with unreasonably small capital.[196] Moody's describes a Caa1 issuer as "seriously undercapitalized relative to its outstanding debt obligations and its level of business risk" and notes that such a rating may be assigned when a "company's equity base is unreasonably thin."[197] Further characteristics of a Caa1 rated company include being unable to withstand flaws in the formulation or implementation of their business plans, weak debt coverage ratios, management team lacking experience in the industry or running highly leveraged companies, and quality of financial disclosure.[198]

Serious undercapitalization is a hallmark of a Caa1 company.[199] Moody's analyzes the owners' equity contribution or market value of equity related to its total debt, as well as the "risk inherent in [the] business" and the "need to have a reasonable equity base to absorb unanticipated setbacks."[200] The owners' willingness (or lack thereof) to contribute capital is a factor considered,[201] as well as owners who wish to cash out, leaving bondholders "holding the bag."[202] Another important

193. STANDARD & POORS, INC., *supra* note 176, at 67.

194. *Id.*

195. *See generally* MOODY'S INVESTORS SERVICE GLOBAL CREDIT RESEARCH, RATING METHODOLOGY: INDUSTRIAL COMPANY RATING METHODOLOGY (1998). Like S&P, Moody's views cash flow as the most important determinant of risk. *Id.* at 1 ("Determining the predictability of future cash generation is the primary focus of Moody's industrial company analysis."). Other factors include industry trends, political and regulatory environment, management quality and attitude towards risk-taking, operating and competitive position, financial position and sources of liquidity, company structure and structural subordination and priority of claims, parent company support agreements and special event risk. *Id.* at 3. Moody's ratings "incorporate assessments of both the likelihood and the severity of default." MOODY'S INVESTORS SERVICE, *supra* note 179, at 5.

196. The Caa1 rating is the highest rating in Moody's Caa ratings group and falls just below a B3 rating. Caa2 and Caa3 ratings are weaker than Caa1. MOODY'S INVESTORS SERVICE, *supra* note 179, at 4–5.

197. *Id.* at 4, 8.

198. *Id.* at 4.

199. *Id.* at 8.

200. *Id.*

201. *Id.* ("The willingness of equity sponsors to contribute capital both initially and in the future can play a critical role in determining a rating.").

202. MOODY'S INVESTORS SERVICE, *supra* note 179, at 9 ("When owners cash out from the proceeds of a note offering, bondholders are generally left to bear the entire financial burden of the leveraged

factor is a company's ability to withstand defects in its business plan.[203]

S&P's and Moody's ratings methodologies are helpful in analyzing the risk of loss to a creditor caused by an unfair transfer and determining when the risk of loss becomes unreasonable and the debtor is left with unreasonably small capital. First, cash flow coverage, and by extension, cash flow cushion, is very important. Second, asset coverage, and by extension, equity cushion, is a factor, but less important, in determining the risk of default. Since loss, not default, is the ultimate determinant of whether creditors are harmed, the asset analysis must be taken further. S&P bases secured debt recovery ratings on encumbered assets (those available to it in the event of default) and the amount of the corresponding collateralized obligation. By analogy, recovery risk borne by unsecured creditors, those most likely to be harmed, should be based on available assets (asset values in excess of outstanding liens) compared to outstanding unsecured obligations.[204] When valuing assets, prospective fair saleable value in the event of default (which may, under the circumstances, be going-concern or liquidation values) should be used. Finally, all other relevant facts and circumstances, such as the various other S&P and Moody's ratings criteria, should be considered.

Financial professionals who prepare solvency analyses in leveraged transactions commonly use a broad-based approach consistent with the methodology advocated in this Note.[205] The unreasonably small capital test used is whether "the 'equity cushion' determined in the balance

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recapitalization. Additionally, a company's operating and financial condition can change dramatically when owners cash-out, and related-party transactions unwind, exposing a company's returns to market conditions that may not be as favorable as those that previously existed.").

203. *Id.* at 11 ("[A]s leverage increases, a company's ability to withstand difficulties arising from an aggressive business model erodes quickly. Lower rated creditors have little liquidity to absorb losses."). Moody's cites early stage telecommunications and other concept companies as prime examples of Caa candidates. *Id.* at 11–12. Moody's notes that "many 'concept—or—business plan' companies in their early stages, particularly those in the telecommunications industry, do not generate operating earnings. These companies rely on continued access to the capital markets to finance network construction and projected rapid growth, as well as to service existing debt." *Id.* at 11. This description aptly describes the situation faced by USN Communications, Inc. (*see, e.g.*, Peltz v. Hatten, 279 B.R. 710, 745–47 (Bankr. D. Del. 2002) (fraudulent conveyance action arising from bankruptcy of USN); *supra* notes 10–12 and accompanying text), which Moody's initially rated a Caa1, and later downgraded to Ca, where it stood as of December 31, 1998. MOODY'S INVESTORS SERVICE, *supra* note 179, at 22. USN filed for Chapter 11 bankruptcy on February 18, 1999. *Peltz*, 279 B.R. at 711. Despite Moody's initial Caa1 rating, *Peltz* held that USN did not have unreasonably small capital. *Id.* at 748.

204. The drafters of the UFTA may have had a similar view of risk. *See supra* note 107 and accompanying text.

205. *See generally* Jeffrey R. Greene & Lori M. Price, *Solvency Analysis in Leveraged Transactions*, *in* FINANCIAL VALUATION: BUSINESSES AND BUSINESS INTERESTS 13-7, 13-10, 13-23 to 13-25 (James H. Zukin & John G. Mavredakis eds., Warren Gorham Lamont 1990). Solvency opinions are often requested by participants in transactions, such as lenders or boards of directors, to reduce the risk associated with fraudulent conveyances. *See, e.g.*, Lisa Arias, *Insurance Policy*, DAILY DEAL/THE DEAL, Nov. 22, 2004; Aaron Pressman, *Bondholders Get Tough; The Threat of Fraudulent Conveyance*, INVESTMENT DEALERS' DIGEST, Nov. 5, 1990, at 18.

sheet test [is] large enough [and] . . . the 'safety margin' in the projections [is] adequate."[206] Factors considered in applying the test include the degree of sensitivity of operating cash flow to changes in key assumptions, the "historical and expected volatility of asset values," the "maturity structure of the company's fixed obligations," the "magnitude, timing and nature of contingent liabilities," the "prevalent capital structures within the industry," and the "amount of flexibility allowed by the financial covenants in the credit agreements."[207] Such financial professionals, who are likely more concerned with professional liability than legal precedent, will presumably use analyses and techniques that are best suited for analyzing the likelihood that a debtor will become insolvent.

Conclusion

The unreasonably small capital provisions of the UFCA, UFTA and Section 548 are intended to protect creditors against unfair asset transfers that leave a company with unreasonably small capital, a financial condition short of equitable or balance sheet insolvency. Such a condition poses an unreasonable risk of loss to creditors. In order to determine whether a transfer left a company in that condition, a three-part test should be applied.

First, the *Moody* test should be applied to determine if the company's cash flow[208] forecasts were reasonable and, if so, whether they left sufficient margin for error (cushion) in the event of reasonably foreseeable difficulties, considering the company's business risks and its obligations. Second, if there was not enough cash flow cushion, or there was a reasonable likelihood that the company would have been compelled to sell its assets,[209] the equity cushion test should be applied to determine whether the fair saleable value of the company's assets exceeded liabilities by a sufficient amount to enable creditors to be paid in full in the event of reasonably foreseeable difficulties. Finally, all other facts and circumstances should be considered (such as factors used by

206. *See* Greene & Price, *supra* note 205, at 13-6.

207. *See id.* at 13-10.

208. "Cash flow" may include the proceeds from the sale of assets not necessary for the continued operation of the business, and proceeds from debt and equity financings, provided that such sales or financings are feasible and likely to occur. Equity financings require extra scrutiny because of the higher level of risk.

209. A company may have a reasonable likelihood of having to sell its assets based on the maturity structure of its debt, contractual obligations (i.e. mandatory redemption of preferred stock of private equity investors), industry or competitive conditions, changes in management or key employees, personal circumstances of controlling shareholders, litigation, regulatory changes, or other conditions that suggest that a sale is likely. In the event of an asset sale, the company's liabilities, if not assumed by the buyer, would have to be satisfied from the proceeds of the sale. If assets were insufficient, the company would be balance sheet insolvent.

rating agencies) that may indicate whether creditors had been subjected to an unreasonably high risk of loss.